REGULATING RISK BY "STRENGTHENING CORPORATE GOVERNANCE"

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This essay, prepared for the "Regulating Risk" symposium of the Connecticut Insurance Law Journal, reviews the connection between risk and corporate governance, then examines the "Strengthening Corporate Governance" provisions of Subtitle G of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). The corporate governance provisions, covering proxy access and the separation of the roles of CEO and chairman of the board, seem likely to have one of two possible effects. On the one hand, the provisions may be pernicious, in that they further enhance shareholder power without a clear justification for increased shareholder power, and more particularly without a justification for shareholder power as a risk management device. Indeed, Dodd-Frank's corporate governance provisions may work at cross-purposes to the risk management intent of the remainder of Dodd-Frank: the corporate governance provisions operate under the assumption that enhanced shareholder power will result in better monitoring of managerial behavior, which presumably will help to prevent future crisis, but both theory and evidence suggest that diversified shareholders generally prefer companies to take risks that other constituencies (including taxpayers) would not prefer.

On the other hand, Dodd-Frank may have very little effect on investor behavior or risk management. Increases in shareholder power over the past years (fundamentally the result of increased federal regulation) have made management more responsive to - and in some cases probably overly responsive to - shareholder concerns over agency costs. Indeed, some of the proposed reforms already have been or were likely to have been put in place at most public companies. If private ordering is already working, what is the point of imposing strict governance constructs across the

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market as a whole, especially when most of the affected firms are victims of, rather than contributors to, the Financial Crisis'

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I. INTRODUCTION

Of the many explanations of the Financial Crisis of 2008, perhaps the most pervasive is the linkage of the crisis to managerial greed: the crisis as the result of managerial expropriation and excessive risk-taking permitted by lax corporate governance and risk management. To assess the characterization of the Financial Crisis as a governance crisis, we must test the strength of the links between managerial behavior, corporate governance and risk management. Certainly, in the run-up to the Financial Crisis existing systems of governance and risk management failed to detect and mitigate firm-level risks before they became systemic risks. Are these failures of risk management ultimately corporate governance failures? If they are, how do we address them?

Regulators and firms can (and do) attack governance problems from multiple angles. Firms incentivize managers better by constructing executive compensation schemes that closely link operating and/or stock performance to compensation. Firms create monitoring systems that allow managers and directors to recognize, evaluate, and mitigate risks to the enterprise, and regulators create monitoring systems within regulatory structures that allow them to recognize, evaluate, and mitigate systemic risks created by a myriad of firm decisions. Regulators provide regulatory support for a vigorous market for corporate control and impose, either through new regulations or through existing corporate governance mechanisms (such as proxy voting), governance structures that limit managerial authority and/or increase managers' accountability to shareholders.

This essay will focus on a specific effort of this last means of managing agency costs—regulated governance arrangements—as a means of managing both systemic and firm-specific risk. The essay will first briefly consider the connection between risk management and corporate governance, showing how the two are often linked. This link is implicitly assumed by the recently passed Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The second part of this essay will consider the Dodd-Frank Act's assumptions concerning risk management and shareholder power, and will argue that in the worst case the Dodd-Frank Act exacerbates rather than mitigates risk, and in the best case is merely a pointless exercise in political crisis management that will

have no significant positive or negative effect on corporate governance or risk management.

II. LINKING RISK MANAGEMENT AND CORPORATE GOVERNANCE

Risk management, broadly conceived, is an essential aspect of good corporate governance, and vice versa. However we define corporate governance (as a description of the relationship between corporate stakeholders, as a set of rules or processes governing the corporate entity, etc.), risk management works hand in hand with corporate governance as a means of constraining agency costs and promoting efficient and prudent management. Indeed, risk management so overlaps with corporate governance that the terms may sometimes be used synonymously. Because risk management practices in many financial firms failed during the Financial Crisis, it has been said that corporate governance failed during the Financial Crisis[1]—if this is true, the Financial Crisis is not a risk management problem but a larger crisis in corporate governance. In this essay I do not seek to dispute that corporate governance failures at some firms contributed to the Financial Crisis. However, even if we assume that this is the case, determining *which aspects* of corporate governance failed is crucial: as Brian Cheffins has noted, important normative implications flow from this determination.[2] If the failure is in part due to incentive compensation systems, should these systems be subject to additional regulation, and if so, how should they be regulated? If the failure is also due to failures of internal controls systems, should we rethink or enhance the regulatory framework under Section 404 of Sarbanes-Oxley?

At the level of each specific firm, the precise nature of the failure of governance and risk management is likely to be somewhat different. Perhaps like Tolstoy's unhappy families,[3] each is unhappy in its own way and failed for reasons that elude a simple narrative of greed or hubris. As we continue to unravel the causes of the crisis, we do find some common factors in the stories of financial firms like Bear Stearns, Lehman Brothers,

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[1] *See* Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 2 (2009).

[2] *See Id.* at 3.

[3] *See* LEO TOLSTOY, ANNA KARENINA 1 (Richard Pevear & Larissa Volokhonsky trans., Penguin Books Deluxe ed. 2002) (1877).

AIG, and others. William Sahlman has aptly summed several common factors:

> In studying the financial crisis as it unfolded over the past couple of years, it seems clear that many organizations suffered from a lethal combination of powerful, sometimes misguided incentives; inadequate control and risk management systems; misleading accounting; and, low quality human capital in terms of integrity and/or competence, all wrapped in a culture that failed to provide a sensible guide for managerial behavior. This assessment refers to financial services firms like Countrywide, AIG and Bear Stearns: it also applies to other actors like regulatory agencies, politicians, ratings agencies and probably to individual consumers.[4]

One of the financial firms that suffered from this "lethal combination," UBS, provided its shareholders with a frank assessment of its risk management and governance failures. The 50-page report[5] provides a helpful catalog of the numerous specific failures at UBS, the majority of which almost certainly affected most other financial firms, including:

- Incomplete risk control methodologies.[6]
- Insufficient challenge of the business case and governance approach.[7]
- Inappropriate risk metrics used in strategic planning and assessment.[8]
- Failure to own the business.[9]

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[4] William A. Sahlman, *Management and the Financial Crisis (We have met the enemy and he is us . . .)* 4 (Harv. Bus. Sch., Working Paper No. 10-033, 2009), *available at* http://www.hbs.edu/research/pdf/10-033.pdf.

[5] UBS AG, SHAREHOLDER REPORT ON UBS'S WRITE-DOWNS (Apr. 18, 2008), *available at* http://www.ubs.com/1/ShowMedia/investors/share_information/shareholderreport?contentId=140333&name=080418ShareholderReport.pdf.

[6] *Id.* at 29.

[7] *Id.* at 33.

[8] *Id.* at 34.

[9] *Id.* at 36.

- Ex-post review versus pre-agreed limits [asking for forgiveness rather than permission].[10]
- Failure to respond to wider industry concerns.[11]
- Over-reliance on VaR.[12]
- Over-reliance on [debt] ratings.[13]
- Lack of recognition of idiosyncratic risk.[14]
- Asymmetric risk / reward compensation.[15]
- Insufficient incentives to protect the UBS franchise long-term.[16]

With UBS, we indeed recognize powerful, sometimes misguided incentives (in the form of trader and management compensation);[17] inadequate control and risk management systems that could not adequately evaluate and respond to risks; misleading accounting (UBS restated its financials for 2008);[18] and, low quality human capital in terms of integrity and/or competence (lack of a willingness to challenge the bankers at UBS, and a decline in the number of skilled risk managers).[19]

If UBS's risk management and governance problems were typical, we might ask how better corporate governance at UBS could have prevented the crisis. Arguably, management (including the board) should

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[10] *Id.* at 37.

[11] UBS AG, *supra* note 5, at 37.

[12] *Id.* at 38. A 2009 article by Joe Nocera contains two pithy quotes from two famous VaR Skeptics:

> David Einhorn, who founded Greenlight Capital, a prominent hedge fund, wrote not long ago that VaR was 'relatively useless as a risk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an air bag that works all the time, except when you have a car accident.' Nassim Nicholas Taleb, the best-selling author of 'The Black Swan,' has crusaded against VaR for more than a decade. He calls it, flatly, 'a fraud.'

Joe Nocera, *Risk Management*, N.Y. TIMES MAG., Jan. 4, 2009, at 24, 26-27.

[13] UBS AG, *supra* note 5, at 39.

[14] *Id.*

[15] *Id.* at 42.

[16] *Id.*

[17] Sahlman, *supra* note 4, at 4.

[18] *Id.*

[19] *Id.*

have recognized the dangers in the subprime market and begun to de-lever (debt to equity ratios were 30:1 at Lehman and Morgan Stanley).[20] With the benefit of hindsight, it seems that UBS's internal controls systems were not adequate, that risk managers were using incomplete information and incomplete models, and that UBS had a culture that was focused on short-term profits and, in the words of the report, had "[i]nsufficient incentives to protect the UBS franchise long-term."[21] But even with the risk management systems then in place, one may ask why risk managers could not anticipate the crisis. I suspect that many risk managers did, in fact, recognize the problems in the housing and credit markets before the crisis, but obviously did not anticipate the magnitude of the problem, nor appreciate the interconnectedness of financial institutions. Some probably did express their concerns to management, and perhaps their concerns were discounted.

A better question might be to ask why managers believed that they could time the market so that they would be able to stop dancing just as the music stopped playing, sure in the knowledge that risks would have been passed along to someone else or adequately hedged, and that we would make the fabled "soft landing" that Fed Chairman Ben Bernanke predicted in February 2007.[22] A partial answer to this question may be found in behavioral explanations of the Financial Crisis, but a simple explanation may also be found in the incentives of the managers. Citigroup, for example, had to "keep dancing," as Chuck Prince put it, in order to stay competitive with other banks. The low rates brought about by Fed policy helped drive the leveraged buyout business; banks like Citi had "no credibility to stop participating in this lending business . . . My belief then and my belief now is that one firm in this business cannot unilaterally withdraw from the business and maintain its ability to conduct business in the future."[23] He believed that "if you are not engaged in business, people leave the institution, so it is impossible to say in my view to your bankers we are just not going to participate in the business in the next year or so

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[20] Michael J. de la Merced, Vikas Bajaj & Andrew Ross Sorkin, *As Goldman and Morgan Shift, a Wall St. Era Ends*, N.Y. TIMES DEALBOOK (Sept. 21, 2008, 9:35 PM), http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/.

[21] UBS AG, *supra* note 5, at 42.

[22] Edmund L. Andrews, *Fed Chief Says Outlook Is Positive*, N.Y. TIMES, Feb. 15, 2007, at C10.

[23] Cyrus Sanati, *Prince Finally Explains His Dancing Comment*, N.Y. TIMES DEALBOOK (Apr. 8, 2010, 2:04 PM), http://dealbook.blogs.nytimes.com/2010/04/08/prince-finally-explains-his-dancing-comment/.

until things become a little more rational. . . You can't do that and expect to have any people left to conduct business in the future."[24]

How, then, should we characterize the governance failures at UBS and other financial firms, and how do they relate to risk management? Certainly the control systems—and particularly the risk management systems—failed, though perhaps not in every case due to a reckless indifference to risk. As with the failure of Long Term Capital Management over a decade ago, the state of the art in hedging and risk management simply was not good enough, and a failure to respond to warning signs and challenge existing models and business practices clearly contributed to the collapse. Moreover, I believe that the incentive structures were also flawed in that traders and originators had incentives to take on excessive risk without internalizing the costs of that risk. Where appropriate limits are placed on trading activities—a real back office check on the risk assumed by the front office—a high-reward incentive structure is less problematic. The problem comes when lax controls are combined with incentives to take heavy risk.

Over both of these areas—risk management systems and incentive schemes—management and the board must provide oversight. Generally, they are obligated to ensure that systems are created and function effectively in controlling (but not hobbling) the animal spirits that drive the business forward. With this understanding, the governance structures at most major financial institutions (excepting perhaps Goldman Sachs) can be said to have failed from a risk management perspective.

Although my description of how risk management failures can be described as failures of corporate governance may not offer the strongest argument in support of the position, I believe that it is at least a reasonable assessment of how the two failures may be linked. But importantly, even if we recognize that the Financial Crisis was a risk management crisis, and that as a risk management crisis it is in effect a corporate governance crisis, we have still only introduced a problem, and have not justified any solution to that problem. If we accept that poor corporate governance at least contributed to the Financial Crisis, we must now turn to the question of how corporate governance can be improved in order to better manage risk. This question was recently addressed in the sweeping Dodd-Frank legislation, in part through Subtitle G: "Strengthening Corporate Governance." In the next section, I will focus on the assumptions

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[24] *Id.*

underlying Subtitle G's corporate governance prescriptions, and on the implications of the prescriptions for risk management.

III. REGULATING CORPORATE GOVERNANCE TO MANAGE RISK

In this section, I will first begin by describing the governance provisions in the Dodd-Frank Act, then turn to an analysis of the assumptions underlying the governance provisions. I will then discuss the implications of the provision, focusing on how they are likely to affect risk management.

A. "STRENGTHENING CORPORATE GOVERNANCE": SUBTITLE G OF THE DODD-FRANK ACT

The first point of interest in the Dodd-Frank Act is its scope: Dodd-Frank's corporate governance provisions are not limited to "too big to fail" firms or financial services firms. They generally apply to any company traded on a national stock exchange. The Dodd-Frank Act does not explicitly preempt state law, but instead applies the SEC's power to approve listing standards of the national stock exchanges.[25] The Dodd-Frank Act contains provisions that affect shareholder rights and that focus on executive compensation.[26] Although appropriate incentive compensation is an important component of an overall corporate governance structure, other papers in this symposium provide a detailed analysis of the advisability of the compensation rules set out in the proposed regulations. This essay will focus on the corporate governance aspects of the Dodd-Frank Act that relate to shareholder rights.

The final version of Subtitle G of the Dodd-Frank Act contains two major corporate governance provisions:[27] 1) explicit approval of an SEC

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[25] Richard J. Sandler, *Corporate Governance and Executive Compensation in the New Dodd Bill*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 17, 2010, 8:34 AM), http://blogs.law.harvard.edu/corpgov/2010/03/17/corporate-governance-and-executive-compensation-in-the-new-dodd-bill/.

[26] *See id.*

[27] Other sections of the Dodd-Frank Act not discussed in this paper also cover important governance-related issues such as say-on-pay. This essay is limited to an analysis of Subtitle G.

proxy access rule;[28] 2) and a comply-or-explain provision on the separation of the CEO and board chairman position.[29] The Senate version of the bill contained a majority-voting requirement, but this was eliminated in a compromise with the House version of the bill.[30] A provision in the 2009 Dodd Bill, absent in all versions of the 2010 bill, would have prohibited classified boards unless approved or ratified by shareholders.[31]

1. Proxy Access

In a shift from the 2009 Dodd Bill,[32] the SEC "may" require proxy access for shareholders, rather than requiring the SEC to issue proxy access rules within 180 days of the Dodd-Frank Act's enactment.[33] In response to this authority, on August 25th, 2010, the SEC approved rules that provided shareholders with the right to place director candidates on the corporate ballot. To be able to nominate a director under this rule, a shareholder or group of shareholders must hold 3% of the company's shares for more than 3 years.[34]

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[28] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 971 (2010) (enacted).

[29] *Id.* § 972.

[30] David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jul. 7, 2010, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation/. In the Senate version of The Dodd-Frank Act, stock exchange listing requirements would have been required to include a majority vote standard in uncontested director elections for all listed companies. Plurality voting was permitted only in contested elections. A director receiving less than a majority of votes cast would have been required to submit his or her resignation. The board could have then refused the resignation, but the bill required that it then publicly explain why it did not accept the director's resignation. The majority voting requirement would not have been met by the plurality-plus voting rules in place at many companies. Sandler, *supra* note 26.

[31] Sandler, *supra* note 25.

[32] *Id.*

[33] H.R. 4173, § 972.

[34] Lucian Bebchuck & Scott Hirst, *Proxy Access Is In*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 25, 2010, 11:20 AM), http://blogs.law.harvard.edu/corpgov/2010/08/25/proxy-access-is-in/.

2. CEO and Chairman Positions

The Dodd-Frank Act requires the SEC to promulgate rules mandating proxy statement disclosure concerning the separation of the CEO and chairman roles—companies must explain why the same or why different persons serve in these roles.[35] Similar disclosure is already required under the "Corporate Governance" disclosures mandated under Item 407 of Regulation S-K. In particular, Item 407(h) requires companies to "[b]riefly describe the leadership structure of the registrant's board, such as whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions...."[36] If one person serves as both CEO and chairman of the board, the company must "disclose whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board."[37] The disclosure should also explain "why the registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the registrant,"[38] and "disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure."[39]

B. ASSUMPTIONS OF THE DODD-FRANK ACT

The corporate governance provisions of the Dodd-Frank Act suggest several tenuous assumptions about the role of corporate governance in preventing financial crises. First, the inclusion of the provisions in the Bill arguably assumes that the governance structures required by the provisions could have helped prevent the Financial Crisis of 2008, or at least limited its effects on compliant firms. More specifically, the Dodd-Frank Act makes assumptions about the desirability of shareholder power and the risk preferences of shareholders. Each of these assumptions has tenuous support.

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[35] Huntington, *supra* note 30.
[36] 17 C.F.R. § 229.407(h) (2010).
[36] *Id.*
[37] *Id.*
[38] *Id.*

1. Could the Provisions have Helped Prevent the Financial Crisis?

There is plenty of blame to go around when one looks for causes of and contributions to the Financial Crisis. The question as posed—could the Dodd-Frank Act's provisions have helped to prevent the Financial Crisis?—may be interpreted so broadly that it becomes unreasonable. I doubt that anyone would argue that the whole of the blame for the Financial Crisis rests on a few corporate governance practices that the Dodd-Frank Act intends to cure. But even if we think of the question more narrowly—that the "right" corporate governance practices could have provided more warning, could have added accountability to corporate governance, could have ensured more independent thinking by the board that may have resulted in decisions that would have at least helped mitigate some of the effects of the crisis—Dodd-Frank implicitly holds expectations of the value of corporate governance. More precisely, the Dodd-Frank Act assumes a need for mandatory, one-size-fits-all corporate governance reform and shareholder empowerment.

As a preliminary matter, the evidence that corporate governance matters for firm performance is uneven.[40] Intuitively, this is primarily due to the fact that "good" corporate governance is firm-specific and often based on qualities, such as corporate culture, that are not readily quantifiable and so are difficult or impossible to reduce to a set of metrics. Determining causation in governance and performance is challenging, and corporate governance research is replete with studies attempting to isolate a particular metric (say, the separation of the CEO and chairman roles) to determine whether the separation improves some measure of firm performance. Much effort has recently gone into determining the accuracy of the good governance metrics offered by governance ratings firms and proxy advisors like RiskMetrics' ISS unit. We have some evidence that some of the metrics used by ratings firms can meaningfully predict

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[40] Bebchuk, Cohen and Wang reason that the failure to find an association between corporate governance and abnormal returns in the last decade is due to the fact that investors have learned to appreciate the differences between good-governance and poor-governance firms, and these differences have been factored into market prices. Lucian A. Bebchuk, Alma Cohen & Charles C. Y. Wang, Learning and the Disappearing Association Between Governance and Returns (unpublished discussion paper, no. 667), *available at* http://ssrn.com/abstract=1589731.

performance, but at least some of these studies were commissioned by or produced by the subject ratings firms.[41] Other independent work suggests that the ratings used by various firms do not accurately predict firm performance.[42] To underline an obvious but often disregarded point, proxy advisory and corporate governance ratings firms are, after all, businesses. They must have something of value to offer their clients, and they must differentiate their products by price or by methodology. It would be problematic for these firms if something basic—for example, share ownership by independent directors, as Professors Bhagat, Bolton and Romano's work suggests[43]—is a more reliable predictor of firm performance than their multitude of metrics. A simple, single metric could be produced by the clients—institutional investors—relatively cheaply. Instead, we have a profusion of proprietary rating systems, each constantly tweaked and recalibrated—a process I call "methodology churn." No two are alike, although the ratings are offered (at least by those firms that do not engage in detailed analysis of the companies they rate by particular governance issue) as though there were a single grand unified theory of corporate governance, perfectly expressed by their proprietary methodology. On this point, I note that Bebchuk, who is generally allied with the governance ratings firms in the general goal of promoting shareholder empowerment, has argued that governance ratings that try to impose a great number of "good governance" metrics on firms are less useful in predicting good governance than simply keying on a few

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[41] *See, e.g.*, Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance (Dec. 7, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586423 (creating a measure of corporate governance based on data from Institutional Shareholder Services).

[42] *See e.g.*, Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices* (Eur. Corporate Governance Inst., Working Paper No. 89, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019921; Robert Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings?* (Arthur and Toni Rembe Rock Ctr. For Corporate Governance, Working Paper No. 360, 2009), *available at* http://law.stanford.edu/display/images/dynamic/publications_pdf/dg16-26-2008_1.pdf (finding that there is no consistent relation between government indices and measures of corporate performance).

[43] Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*.

problematic entrenchment devices such as poison pills[44]—in other words, it seems easier to spot "bad governance" structures than it is to effectively prescribe "good governance" structures.

The problems with the corporate governance industry metrics are instructive with respect to the particular provisions of the Dodd-Frank Act. As we inch closer towards a federally-mandated, one-size-fits-all corporate governance framework, companies, investors and regulators may begin to treat corporate governance and particular governance structures as an end rather than as means. Should we be surprised then, as ISS must have been, when a technically, superficially well-governed company like Enron turns out to be a whited sepulcher? Little faith should be placed in the risk management utility of mandatory "good governance" structures, and the Dodd-Frank Act provisions require practices and structures which, as will be discussed below, have uncertain governance value and potentially serious governance disadvantages.

2. Shareholder Power and the Risk Preferences of Shareholders

Cheffins has noted that "given the *zeitgeist*, it is doubtful whether any set of corporate governance arrangements could have forestalled the financial bandwagon on the loose in the mid-2000s. Amidst an implicit consensus among investors, politicians, regulators, journalists and even homebuyers that an overheating financial system was fundamentally sound, those preaching caution were marginalized."[45] The irony of the Dodd-Frank Act is that things may have been worse if the Act were in place prior to the Financial Crisis. Indeed, it is when we analyze the Act's assumptions about shareholder power and shareholder risk preferences that we recognize that investors were among those encouraging the banks to keep dancing.

Because shareholders, the residual claimants of the corporation, are diversified across markets and often across asset classes, they will often push management to swing for the fences. The Dodd-Frank Act assumes that shareholders are primarily interested in long-term value creation, but this assumption does not square with the behavior of many investors. Shareholders may have different risk preferences and attempt to influence

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[44] *See* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance*, 22 REV. FIN. STUD, 783, 787 (2009).

[45] Cheffins, *supra* note 1, at 38.

managers to make decisions in line with those preferences. As outlined by the Aspen Institute's statement on "Overcoming Short-Termism,"[46] signed by John Bogle, Warren Buffett and others, the influence of money managers, mutual funds and hedge funds "who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns"[47] present several problems. First, many such investors' preferences work not only against other long-term-focused shareholders but against their ultimate investors' interests because high rates of portfolio turnover through frequent trading can significantly erode gains.[48] Second, fund managers focused on short-term trading gains "have little reason to care about long-term corporate performance or externalities, and so are unlikely to exercise a positive role in promoting corporate policies, including appropriate proxy voting and corporate governance policies, that are beneficial and sustainable in the long-term."[49] Also, managers and board members may harm the interests of shareholders seeking long-term growth and sustainable earnings by pursuing strategies designed to satisfy short-term investors; "This, in turn, may put a corporation's future at risk."[50]

Deeper shareholder involvement in corporate governance, as encouraged by the Dodd-Frank Act's corporate governance provisions, is designed to encourage more vigilant monitoring of managers and more prudent risk management. However, the UK experience suggests that this is unlikely to be the case. As Cheffins notes:

> U.K. company law is, in various respects, more "shareholder-friendly" than the equivalent regime in the U.S., as U.K. shareholders have greater scope to call shareholder meetings, initiate changes to the corporate constitution and dismiss directors. . . . Regardless, it does not appear that banks were better managed in the U.K. than in the U.S. Moreover, bank shareholders apparently made

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[46] THE ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/images/Overcoming%20Short-termism%20AspenCVSG%2015dec09.pdf.

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

> little use of the powers available to them. The chief executive of the U.K.'s financial markets regulator admonished major shareholders for being "too reliant and unchallenging" in the run up to Financial Crisis. Lord Myners, Financial Services Secretary in the U.K. Treasury, similarly chastised institutional shareholders as being "absentee landlords". The experience in Britain implies that even if shareholder rights are increased in the U.S. in the aftermath of the stock meltdown of 2008, there is no guarantee shareholders will use the powers made available to them to forestall a similar future assault on shareholder value.[51]

David Walker, commissioned by the Prime Minister to review UK banks' corporate governance in the wake of the Financial Crisis, makes a similar observation, and suggests that in some cases shareholder were complicit in excessive risk-taking:

> Before the current crisis broke there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of banks' balance sheets as a means of boosting returns on equity. This was not necessarily irrational from the standpoint of the immediate interests of shareholders who, in the leveraged limited liability business of a bank, receive all of the potential upside whereas their downside is limited to their equity stake, however much the bank loses overall in a catastrophe. The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances. And, while institutional investors could not have prevented the crisis, even major fund managers appear to have been slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively. The limited institutional efforts at engagement with several UK banks appear to have had little impact in restraining management before the

[51] Cheffins, *supra* note 1, at 45-46.

> recent crisis phase, and it is noteworthy that levels of voting against bank resolutions rarely exceeded 10 per cent.[52]

Viewed in this light, shareholder power may not only fail to remedy risk management problems but also exacerbate them. If we view the Financial Crisis as a governance problem, it is not clear that the crisis is attributable to expropriation of principals' interests by management shareholders. Nestor Advisors, a corporate governance consultancy, argues that management does not seem to have short-changed shareholders in the Financial Crisis. Executives' financial interests were aligned with shareholders' interests. But in the case of banks, especially, this can be problematic: "Regulators, like everyone else, seem to have forgotten that, when it comes to firms that are by definition highly geared due to their maturity transformation function, full alignment with shareholder interest might be the riskiest of all alignments."[53]

At least from the point of view of banks, the shareholder empowerment envisioned by the corporate governance section of the Dodd-Frank Act thus may work at cross-purposes to the risk management purposes of the remainder of the Dodd-Frank Act. But even with non-financial companies, there is little evidence to support the notion that enhanced shareholder power as encouraged by the Dodd-Frank Act will improve the risk management function of corporate governance. Indeed, to the extent that influential shareholders encourage risk-taking by managers, the long-term interests of the corporation may suffer.

As a final note, consider the performance of Goldman Sachs in the Financial Crisis.[54] Because of a strong firm culture, Goldman's management was arguably the best-insulated from influential shareholder pressure; arguably, their relative success in navigating the crisis lies in the fact that Goldman treated risk management as though it were still a

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[52] DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES § 5.9 (2009), *available at* http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf; *see generally id.* § 5 (discussing engagement, stewardship, collective action and governance).

[53] NESTOR ADVISORS, GOVERNANCE IN CRISIS: A COMPARATIVE CASE STUDY OF SIX US INVESTMENT BANKS 17 (2009), *available at* http://www.nestoradvisors.co.uk/fileadmin/user_upload/articles/USBank09.pdf.

[54] For a discussion of Goldman in the Financial Crisis, see Nocera, *supra* note 12; Sahlman, *supra* note 4.

partnership—with partners internalizing losses as well as gains—rather than a corporation influenced by the short-term interests of certain investors.

3. The Act's Provisions: Pernicious or Merely Pointless?

Given the potential higher appetite for risk associated with increased shareholder power, the Dodd-Frank Act's corporate governance provisions seem to provide little enhancement to risk management. The corporate governance provisions are better understood as not directed towards the causes of the Financial Crisis, but rather as simply not letting a crisis go to waste[55]—packaging corporate governance reforms that have been long-sought by powerful Democratic constituencies with a bill that should be directed solely towards systemic risk management. More to the point, the corporate governance provisions would not be good legislation even if they stood alone, unconnected to the questions of risk management raised by the Financial Crisis. In the aggregate, the Dodd-Frank Act's corporate governance provisions are likely to have pernicious[56] effects. Hopefully they will be merely pointless.

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[55] *See* Jeff Zeleny & Jackie Calmes, *Obama, Assembling Team, Turns to the Economy*, N. Y. TIMES, Nov. 7, 2008 at A1.

[56] In my symposium remarks, I noted the possibility that the Dodd-Frank Act could have pernicious effects on corporate governance, but I was not the only one to characterize the provisions in this way. *See also* Steven M. Bainbridge, *The Fruits of Shareholder Activism*, PROFESSORBAINBRIDGE.COM (June 3, 2010, 11:25 AM), http://www.professorbainbridge.com/professorbainbridgecom/wall-street-reform/ (Steven Bainbridge provides an excellent analysis of the pernicious corporate governance provisions of Dodd-Frank).

a) The Potentially Pernicious Effects of the Dodd-Frank Act[57]

Proxy access has generated the most controversy of the two adopted provisions, having been the subject of several proposed SEC rules that generated thousands of comments. Like majority voting, proxy access is touted by its proponents as a step towards more democratic governance of the public corporation (notwithstanding the questionable value of democracy as applied to the corporate form[58]). However, empirical work on proxy access suggests that it is more likely to harm than help corporate governance. Grundfest, reviewing recent studies on stock price response to the SEC's earlier proxy access proposals, states that:

> The best currently available empirical data thus indicate that, given a choice between the current regime and the Commission's proposed proxy access rules, shareholders seeking to maximize returns would prefer the status quo because the proposed rules appear to destroy shareholder wealth. Moreover, if there is to be a proxy access rule, the cross-sectional variation in the data suggest that an opt-in regime, in which shareholders define for themselves the rules governing proxy access on a corporation-by-

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[57] As indicated above, the majority voting standard was eliminated from the final version of the Act. This is just as well, because majority voting has been enacted at many public companies already, largely as a result of consistent pressure from institutional investors and the corporate governance industry in the past decade. *See* William K. Sjostrom & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 462 (2007). A recent study of the governance practices of the largest U.S. companies, conducted by Shearman and Sterling LLP, showed that 82 out of the top 100 companies had implemented some form of majority voting in director elections. SHEARMAN & STERLING, CORPORATE GOVERNANCE OF THE LARGEST US PUBLIC COMPANIES 4 (2010). As most of the larger public companies have enacted majority voting provisions, the mandatory imposition of majority voting provisions would have affected smaller public companies most directly. For a summary of the arguments against a majority voting standard, see Sjostrom & Kim, *supra*, at 469.

[58] For an extended argument on the merits of democracy in business entities, see DINO FALASCHETTI, DEMOCRATIC GOVERNANCE AND ECONOMIC PERFORMANCE: HOW ACCOUNTABILITY CAN GO TOO FAR IN LAW, POLITICS, AND BUSINESS (2009).

> corporation basis, is likely preferable to an opt-out regime, in which the Commission has to guess at an optimal default rule, and where the data indicate that the Commission's current best guess destroys a statistically significant amount of shareholder wealth.[59]

Why would at least some shareholders be concerned with greater shareholder power? Because larger shareholders with proxy access may use the threat of a proxy fight to extract private benefits from a corporation—perhaps merely by using the proxy as a megaphone for the shareholder's causes (imposing what Grundfest calls "megaphone externalities")[60]—or simply to pursue idiosyncratic corporate governance changes that the shareholder (but not management or the majority of the other shareholders) believes are necessary.

Buckberg and Macey provide several arguments against proxy access in a report accompanying the Business Roundtable's comments on the SEC's 2009 proxy access proposal.[61] They find that proxy access is unnecessary given numerous effective mechanisms to discipline management, that proxy contests under the pre-Dodd-Frank rules were not prohibitively expensive, and that the SEC's proposed rules would inefficiently allocate benefits and costs of proxy contests and would not distinguish between the issues associated with expressing disapproval of an incumbent director and the issues associated with identifying, nominating, legitimating, and electing an outside insurgent director, among other reasons. They also argue that an increase in proxy-related costs is a predictable and inevitable result of proxy access:

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[59] Joseph A. Grundfest, *Measurement Issues in the Proxy Access Debate* 3-4 (Rock Ctr. For Corp. Governance, Working Paper Series No. 71, Stan. Univ. L. Sch. L. and Econ. Olin, Working Paper Series No. 392, 2010), *available at* http://ssrn.com/abstract=1538630.

[60] Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law* 4 (Rock Ctr. For Corp. Governance, Working Paper Series No. 64, Stan. Univ. L. Sch. L. & Econ. Olin, Working Paper Series No. 386, 2009), *available at* http://ssrn.com/abstract=1491670.

[61] *See* ELAINE BUCKBERG & JONATHAN MACEY, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION IN SUPPORT OF COMMENTS BY BUSINESS ROUNDTABLE (2009) (stating that risks of the SEC's proposal include less qualified boards of directors, board members whose interests diverge from maximizing shareholder value, a disincentive to go public, and increasing the cost of capital for U.S. companies).

> It is a well-known result in economic theory that when the marginal social cost of an activity exceeds its marginal private cost, as is the case with any subsidy, more of that activity will take place. In the case of the proposed SEC rule, the marginal social cost of a shareholder nominating a director is higher than the marginal private cost because the costs of the contested election are borne in part by the issuer, rather than the nominating shareholder. This subsidy will inevitably increase the number of director nominations by shareholders.[62]

Lowering the cost of proxy access leads to a pernicious result, particularly when the right of access is conditioned upon a relatively low level of shareholder ownership: proxy rules give influence to investors with less to lose from the poor performance of the company and more to gain through private benefits. Even if the dissident shareholders are interested in wealth maximization for all shareholders, Buckberg and Macey present evidence that companies with dissident board members significantly underperform peer companies without dissident directors.

Dodd-Frank's other Subtitle G corporate governance provision, a comply-or-explain provision that would require disclosure on the CEO and chairman of the board of directors (COB) positions, may also have pernicious effects. The policy justification for splitting the two roles is thin. Oded, Palmon and Wald argue that while a management structure in which two executives hold the CEO and COB may facilitate checks and balances and thus may mitigate management agency costs, a management structure in which one person holds both positions provides a clearer set of directives for the companies and facilitates better communication between boards and management.[63] Results from the UK also show that splitting the roles does not appear to produce positive effects. In a recent study, Dahya, Garcia and van Bommel reviewed the performance of publicly listed U.K. companies over a period covering the issuance of the Cadbury Committee's Code of Best Practice, which advocated splitting the CEO/COB positions.[64]

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[62] *Id.* at 8.

[63] Oded Palmon & John K. Wald, *Are Two Heads Better than One: The Impact of Changes in Management Structure on Performance by Firm Size*, 8 J. CORP. FIN. 213, 214 (2002).

[64] Jay Dahya, Laura Galguera Garcia & Jos van Bommel, *One Man Two Hats: What's All the Commotion!*, 44 FIN. REV. 179 (2009).

They found that companies splitting the combined CEO/COB position did not exhibit any absolute or relative improvement in performance when compared to various peer-group benchmarks.[65] These findings are supported by a study by Dey, Engel and Liu.[66] They examined the effects of US firms that had split the CEO/COB position and ones that had not, and noted that there was no significant difference in either the accounting or market return performance. In fact, when firms had a powerful CEO, strong information flows and strong governance, in addition to a combined CEO/COB position, returns were significantly higher than both combined CEO/COB firms without these traits and firms with separate roles for their CEO and COB. They conclude that regulators should be wary about implementing a one-size-fits-all requirement for this position, as some firms appear to benefit from the combined arrangement.

This section has addressed the potentially pernicious effects of the Dodd-Frank Act as stand-alone provisions, but there is also a general concern over what Bainbridge calls the "creeping federalization" of corporate law. Bainbridge argues that:

> [T]he uniformity imposed by [the Dodd-Frank Act] will preclude experimentation with differing modes of regulation. As such, there will be no opportunity for new and better regulatory ideas to be developed—no "laboratory" of federalism. Instead, we will be stuck with rules that may well be wrong from the outset and, in any case, may quickly become obsolete.[67]

With respect to corporate governance, the Dodd-Frank Act's one-size-fits-all governance structures will not reduce either company or systemic risks, and instead will incrementally reduce the flexibility and value of state regulation of public corporation governance. Ribstein notes the irony of establishing a rule that supposedly empowers shareholders, yet

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[65] *Id.*

[66] Aiyesha Dey, Ellen Engel, Xiaohui Gloria Liu, *Determinants and Implications of Board Leadership Structure,* UNI. CHI BOOTH SCH. BUS RES. PAP., (Jun. 2009).

[67] Stephen M. Bainbridge, *The Pernicious Corporate Governance Provisions of the Dodd Bill*, PROFESSORBAINBRIDGE.COM (Apr. 22, 2010, 2:07 PM), http://www.professorbainbridge.com/professorbainbridgecom/2010/04/the-pernicious-corporate-governance-provisions-of-the-dodd-bill.html.

at the same time eliminates their ability to choose something other than a federally-mandated proxy structure:

> The real problem is that the SEC has barred any possibility for the shareholders or state law to provide for less proxy access than under the new rule. How can a rule that bars shareholders from making certain types of governance rules, either directly or by choosing the state of incorporation, increase shareholder participation in governance?
>
> Perhaps the answer is that shareholders shouldn't participate in governance because they are too easily manipulated and misled and simply don't know what's good for them. Rather, the SEC knows best. . . . Consider the most obvious anomalies: If the shareholders can't be trusted to decrease proxy access, why should they be trusted to increase it? If we fear that managers, even with the new proxy rule, can still manipulate shareholders, then why trust the shareholders to do anything? And if the shareholders can't be trusted, why should the securities laws force firms, at great cost, to inform shareholders so they can participate in the proxy process? In other words, the rule is fundamentally inconsistent with the whole point of the securities laws to provide the disclosure necessary to enable the shareholder to be effective governors of their firms.[68]

b) The Pointlessness of the Dodd-Frank Act's Corporate Governance Provisions

Even if one assumes that the Dodd-Frank Act's corporate governance provisions are good policy, given recent trends in state law and the private ordering of corporate governance, the provisions appear to be pointless, rather than pernicious; reminiscent of Cunningham's memorable

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[68] Larry Ribstein, *The SEC vs. shareholders*, TRUTH ON THE MARKET (Aug. 30, 2010, 9:15 AM), http://truthonthemarket.com/2010/08/30/the-sec-vs-shareholders/.

characterization of the Sarbanes-Oxley "yawn,"[69] the Dodd-Frank Act might also represent more rhetoric than reform. While the corporate governance provisions are unlikely to produce any significant benefits (and many would argue that Sarbanes-Oxley did not either), the direct costs will certainly be less significant than Sarbanes-Oxley's. Dodd-Frank's provisions may simply not have much of an effect on corporate governance.

In the case of proxy access, shareholders in the most important corporate jurisdiction, Delaware, had the ability prior to the enactment of Dodd-Frank to select shareholder proxy for their firms. Delaware General Corporation Law section 112 provides that "[t]he bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder. At least in Delaware, private ordering was already possible, making the Dodd-Frank proxy provisions pointless unless it is the case that shareholders are impeded from exercising their right to nominate shareholders under the DGCL. In the adopting release for the proxy access rules, however, the SEC argued that:

> corporate governance is not merely a matter of private ordering. Rights, including shareholder rights, are artifacts of law, and in the realm of corporate governance some rights cannot be bargained away but rather are imposed by statute. There is nothing novel about mandated limitations on private ordering in corporate governance.

The SEC then argued that private ordering is less desirable because a "company-by-company shareholder vote on the applicability of Rule 14a-11 would involve substantial direct and indirect, market-wide costs." A compromise solution—the ability for companies to opt out of the proxy access rules—was rejected because "management can draw on the full resources of the corporation to promote the adoption of an opt-out, while disaggregated shareholders have no similarly effective platform from which to advocate against an opt-out." Finally, even where

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[69] Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Just Might Work)*, 35 CONN. L. REV. 915 (2003).

proxy rights are granted pursuant to a provision like DGCL sec. 112, the SEC noted that "the board of directors is ordinarily free, subject to its fiduciary duties, to amend or repeal any shareholder-adopted bylaw."

Although I do not believe these arguments carry the burden of proof that would justify such important mandatory governance changes, especially given the pernicious effects outlined by Buckberg and Macey, the importance of this change may prove to be less significant than the arguments against proxy access have suggested. Some hope that this may be the case comes from the Canadian experience with proxy access. Although proxy access is available to investors in Canadian firms, that access is rarely used.[70] The reason, a Canadian lawyer suggests, is that using the corporation's proxy would put the shareholder activist at "a tactical disadvantage."[71] If activists use the corporate proxy, they would be limited to the restrictions of the corporate proxy (presumably including word limitations). Effectively, activists tend to view the ability to control the message as worth the costs of a proxy solicitation. The hope that investors will only use proxy access as a means of reducing managerial agency costs is dampened by the likelihood that even if shareholders rarely use proxy access in the U.S, activists may credibly use the threat of proxy access as a lever with corporations to extract private benefits. One means of neutralizing this threat is to make clearer to other shareholders the effects of this leverage. Exposing this leverage, by requiring enhanced disclosures of shareholder involvement in corporate governance matters, may help prevent some of the harmful aspects of proxy access predicted by its detractors.[72]

The provision on the separation of the CEO and chairman roles seems much less likely than proxy access to have an impact on governance since it has already been enacted in principle.[73] Perhaps like the proxy access provision, the CEO-Chairman disclosure provision was included simply to provide legislative protection for the SEC's rulemaking efforts. Even if this were a new rule, however, it would likely not have a significant

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[70] Lisa Fairfax, *Some Canadian Perspective on Proxy Access*, THE CONGLOMERATE (Mar. 9, 2010, 1:03 PM), http://www.theconglomerate.org/2010/03/some-canadian-perspective-on-proxy-access.html.

[71] *Id.*

[72] For a discussion of the effects of shareholder influence and a proposal of possible disclosure rules that would address the enhanced shareholder influence created by the Dodd-Frank Act, see Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355.

[73] Dahya, Galguera, Garcia & van Bommel, *supra* note 64, at 180.

effect. In some cases, comply-or-explain sorts of provisions tend to have the effect of mandatory governance rules because of the costs of non-compliance (either through burdensome disclosures or because of the shaming aspect intended by the disclosure). This may be the case, for example, with the disclosure of a code of ethics required under Section 406 of the Sarbanes-Oxley Act. In the case of the separation of the CEO and chairman roles, however, combining the two roles is not intuitively inappropriate; on the other hand, shareholders might reasonably wonder why a company would not have a code of ethics.

III. CONCLUSION

This essay has briefly reviewed the connection between risk and corporate governance and the specific corporate governance provisions of the Dodd-Frank Act. The corporate governance provisions, covering majority voting for director elections, proxy access, and the separation of the roles of CEO and chairman of the board, seem likely to have one of two possible effects. On the one hand, the provisions may be pernicious—and the proxy access rules seem very likely to fall into this category—in that they further enhance shareholder power without a clear justification for enhanced shareholder power, but more particularly without a justification for shareholder power as a risk management device. Indeed, the Dodd-Frank Act's corporate governance provisions may work at cross-purposes to the risk management intent of the remainder of the Dodd-Frank Act: the corporate governance provisions operate under the assumption that enhanced shareholder power will result in better monitoring of managerial behavior, which presumably will help to prevent future crisis, but both theory and evidence suggest that diversified shareholders generally prefer companies to take risks that other constituencies (including taxpayers) would not prefer. Empowering shareholders further will not change the nature of the shareholders' interest in risk-taking since they are limited in their downside risk; if influential shareholders focus on long-term rather than short-term gains, it will be because of market forces, not because they have been empowered by the Dodd-Frank Act.

On the other hand, the Dodd-Frank Act may have very little effect on investor behavior or risk management. This is probably the case for the CEO/COB split provision. Increases in shareholder power over the past years (fundamentally the result of increased federal regulation) have made management responsive—and in some cases probably overly responsive to—shareholder concerns over agency costs. If private ordering is already working, what is the point of imposing strict governance constructs across

the market as a whole, especially when most of the affected firms are victims of, rather than contributors to, the Financial Crisis?